

17 February 2009

Asterand

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/06	7.5	(2.2)	(2.1)	0.0	N/A	N/A
12/07	7.6	(1.3)	(1.4)	0.0	N/A	N/A
12/08e	15.1	3.6	3.3	0.0	5.0	N/A
12/09e	13.1	1.1	1.0	0.0	16.5	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Full-year resilience

Asterand has shown itself to be highly resistant to current market turbulence, its stock having risen by 91% in 2008. The driver of last year's performance was a licensing deal that we had not forecast, and we view the core business, which on a stand-alone basis is moving to profitability, as a key factor underpinning the current investment case. We have updated our financial forecasts for currency exchange movements.

Full-year profitability

Asterand's core business remains on track to hit profitability this year. First-half results showed a strong turnaround, with 43% sales growth, and management has indicated that the third quarter was even stronger. We expect a year-end cash balance of £6.8m, and see the US business more than making up for some continuing pressure on UK drug discovery services.

Use of cash?

Management has indicated that paying a dividend is not in its plans, and we expect merger and acquisition activity to feature as a key driver of additional growth. Targets include small, private businesses operating in similar areas, as well as larger companies that could complement Asterand's offering.

Allergan, BTG and other IP

In addition to generating underlying business growth, Asterand could in the longer term sign further deals covering its non-core IP. Two projects have already been licensed out: an ocular disease programme (R99) that brought in \$6.25m up front from Allergan last year, and a potential anti-migraine molecule (BGC20-1531) being taken through clinical trials by BTG.

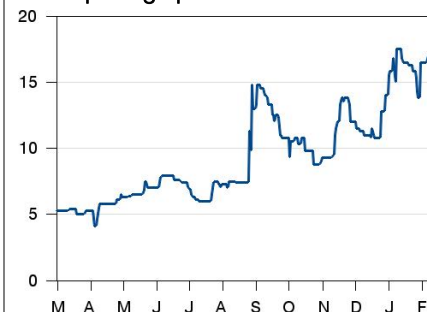
Valuation: Mid-case suggests £24.6m

We have adjusted our financial model for the strengthening of the US dollar vs sterling. This has also had an effect on our valuation, which comprises a DCF taken out to 2013 and an rNPV of the Allergan deal. A mid-case scenario, using a 12.5% WACC and 5% terminal growth rate, suggests a value of around £24.6m. Future IP deals provide potential upside to our assumptions.

Asterand is a research client of Edison Investment Research Limited

Price 16.5p
Market Cap £19m

Share price graph



Share details

Code ATD
Listing FULL
Sector Pharmaceuticals & Biotechnology
Shares in issue 110m

Price

52-week High 17.75p Low 4.25p

Balance sheet as at 31 December 2008*

Debt/Equity (%) N/A
NAV per share (p) 10.0
Net cash (£m) 6.8

*Edison estimate

Business

Asterand supplies human tissue and tissue-related products as well as tissue testing-based services to R&D companies, many of them big pharmas. It was formed in January 2006 through the reverse takeover of the UK's Pharmagene by the private US firm Asterand.

Valuation

	2007	2008e	2009e
P/E relative	N/A	67%	179%
P/CF	N/A	4.0	7.5
EV/Sales	2.0	0.8	0.7
ROE	N/A	32%	9%

Geography based on revenues

UK	Europe	US	Other
4%	13%	80%	3%

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Investment summary: Profitability despite market turbulence

Thanks to its agreement with Allergan for a programme targeting ocular diseases, we expect Asterand to show strong full-year profits when it reports its 2008 financial results in March. The company's core underlying business itself is also moving to profitability and is set to drive future growth. The resulting cash generated (we estimate a resulting balance of £6.8m at the end of last year) gives Asterand considerable flexibility. Management has indicated that paying a dividend is not in its plans, and we therefore expect merger and acquisition activity (possibly using stock as well as cash) to feature as a means of providing additional growth.

The company had earlier stated that the third quarter had shown revenue growth in excess of the 43% year-on-year increase seen in the first half, which was broadly in line with our forecasts. In this note we update our financial model, adjusting most importantly for the strengthened US dollar vs sterling, which has increased US-generated revenue as well as costs.

Supplier of human tissue and services

As a specialist provider of human tissue samples and associated services, Asterand offers customer companies years of expertise in this highly fragmented market, with the advantage of a large tissue biobank and an extensive tissue procurement network. Having become cash-generative, we expect Asterand to turn to possible acquisitions. Targets include small, private businesses operating in similar areas, as well as larger companies that could complement Asterand's offering, possibly adding capability in areas such as *in silico* modelling or stem cells. Businesses currently near break-even could be made profitable through post-acquisition synergies.

The current market is highly fragmented but growing fast, fuelled by big pharma's drive to cut drug development times and increase R&D productivity, as well as a growing focus on biomarkers. Asterand operates a tissue sample supply business in the US, and a UK CRO/service offering carrying out studies for client companies (see Exhibit 1).

Exhibit 1: Asterand's business offering

Service	Description	Business unit	Location
XpressBANK	Biobank of over 200,000 tissue samples and associated clinical and pathology data. Available fixed (in paraffin blocks) or flash-frozen in nitrogen; or as Quad Sets (matched pairs of diseased and adjacent normal tissue; see below). Blood, sputum and tissue derivatives (RNA, DNA, cell lines, etc) also available.	Tissue products	Detroit, Michigan
ProCURE	An on-demand service for clients wanting samples not currently in Asterand's biobank. Asterand effectively uses its network to procure the desired tissue.	Tissue products	Detroit, Michigan
Target validation	CRO service comprising gene expression and gene and protein localisation work focusing on identifying where targets are expressed in tissue/disease types.	PhaseZERO service	Royston, UK
Compound profiling	CRO service dealing with work on live tissues/live cells. Involves investigating drug candidates' pharmacology, looking at mechanical responses in whole tissue preparations or biochemical responses in isolated cells or fractions.	PhaseZERO service	Royston, UK
ADMET	CRO work on drug metabolism, absorption and interaction, <i>in vitro</i> toxicity and safety pharmacology.	PhaseZERO service	Royston, UK

Source: Company presentation; Edison Investment Research

BioWisdom alliance

Asterand recently signed a deal to integrate its human gene expression data into the discovery platform of BioWisdom, a private company that provides healthcare firms with a categorised database of drug development-related intelligence. Asterand's database consists of quantitative human gene expression profiles that chart the expression topography of more than 2,500 commercially relevant gene transcripts across a panel of 72 human tissues.

This effective cross-licensing agreement served as another endorsement of Asterand's industry offering. However, because its terms were not disclosed and because we do not expect it to have a significant effect on near-term financials, we have not considered it in our model.

Allergan and other IP assets

The ocular disease programme (R99) that Asterand succeeded in licensing out to Allergan in August 2008 was one of several IP assets that Asterand had inherited from Pharmagene but on which it was no longer focusing. Under the deal, Allergan paid Asterand a one-off amount of \$6.25m in cash – a relatively high sum for a project still at the early stages of preclinical development. The headline value of the deal amounted to \$56m in up-front and milestone payments in addition to a royalty on sales, with what we believe to be more than half of the total being weighted towards post-approval milestones.

Asterand's IP portfolio contains several such non-core assets. One, a prostaglandin EP4 receptor antagonist that inhibits PGE2-induced vasodilatation of cerebral blood vessels, is licensed to BTG and last year entered Phase I studies for treating migraine. Two human volunteer model studies are planned to aid dose selection before Phase II trials (planned in H109, subject to a portfolio review following BTG's takeover of Protherics).

At least one other non-core project has existing Phase I data, and the IP portfolio (nine discrete potential development projects in total) could provide future upside to our valuation case if projects are licensed to partners for development. Another possible licensing scenario concerns the R99 project in non-ocular indications. These were specifically left out of the Allergan agreement, and it is possible that another company (or indeed Allergan) might license these in later.

The above future scenarios are not currently factored into our financial model or valuation for Asterand, as it is not possible to make an accurate forecast of the magnitude of potential up-front or milestone payments. Rather, we view potential future deals as providing upside to our current model and assumptions.

Financials

An updated financial model is presented in Exhibit 3, and has been updated for exchange rate effects. The strengthened US dollar has flattered tissue supply revenue, which is primarily billed in US dollars, but also increased US-based costs. Accordingly there is no major change to our profitability forecast.

We expect Asterand's tissue supply business to post strong year-on-year growth, with continued demand for human tissue and tissue-based services in research remaining strong despite adverse market conditions for companies more exposed to typical economic cycles, more than making up for the UK CRO drug discovery services activities, which have continued to come under some pressure but have been restructured.

For the time being, we are including the \$6.25m up-front payment from Allergan in full on the income statement (whether recognised in full or spread over a longer period of time, the cash flow effect is unchanged). We do not expect any further milestones from Allergan until after 2009. Revenue also includes around £880k under Asterand's deal with the US Department of Defense for assessment of the Armed Forces Institute of Pathology biorepository. This deal has been completed successfully, and a decision had yet to be taken as to the best use that the collection can be put towards. We reiterate the possibility of additional government work for Asterand on the back of this.

We expect Asterand to have finished 2008 with £6.8m in cash, and it has an additional £2m credit facility available.

Valuation

In our September 2008 note we outlined our two-part methodology for valuing Asterand – one a DCF valuation of the core business, with financial forecasts taken out to 2013, and the other a risk-adjusted net present valuation of future revenue streams (in terms of estimated milestone payments and royalties on sales) that Asterand stands might receive under the Allergan deal.

We have conducted this valuation again, using the amended figures in our financial model. As the combined valuation model depends on the discount rate used, we are again presenting the result as a matrix considering a range of discount rates and assumptions for the terminal growth rate. We present this in Exhibit 3, and note that a mid-case scenario suggests a value of around £24.6m.

Exhibit 2: Asterand valuation matrix

Note: Assumes terminal growth is reached in 2013; * weighted average cost of capital.

WACC*	10%	12.5%	15%
Terminal growth rate			
3%	£28.4m	£21.5m	£17.3m
5%	£35.5m	£24.6m	£19.0m
7%	£51.9m	£30.1m	£21.6m

Source: Edison Investment Research

We plan to review our forecasts and valuation once Asterand reports 2008 full-year figures, expected in March 2009.

Exhibit 3: Asterand financial forecasts

Note: In 2005 Asterand Inc and Pharmagene existed as separate entities, and their figures have been combined below. 2006 cash flow shows merger and Pharmagene cash under financing.

Year end 31 December	£'000s	2005 (combined)	2006 IFRS	2007 IFRS	2008e IFRS	2009e IFRS
PROFIT & LOSS						
Revenue		5,630	7,535	7,608	15,113	13,140
Cost of sales		(3,480)	(4,030)	(4,112)	(7,157)	(7,160)
Gross profit		2,150	3,505	3,496	7,956	5,980
EBITDA		(6,827)	(1,912)	(1,214)	3,787	1,322
Operating profit (before GW and except.)		(7,371)	(2,457)	(1,597)	3,555	1,072
Goodwill amortisation		0	0	(14)	(14)	0
Exceptionals		(2,369)	(463)	(570)	(350)	0
Other		40	36	108	(70)	(100)
Operating profit		(9,700)	(2,884)	(2,073)	3,121	972
Net interest		536	225	150	65	100
Profit before tax (norm)		(6,795)	(2,196)	(1,339)	3,550	1,072
Profit before tax (FRS 3)		(9,164)	(2,659)	(1,923)	3,186	1,072
Tax		401	187	(24)	(15)	(25)
Profit after tax (norm)		(6,434)	(2,045)	(1,471)	3,605	1,147
Profit after tax (FRS3)		(8,763)	(2,472)	(1,947)	3,171	1,047
Average number of shares outstanding (m)		N/A	99.4	106.2	110.6	113.2
EPS - normalised (p)		N/A	(2.1)	(1.4)	3.3	1.0
EPS - FRS 3 (p)		N/A	(2.5)	(1.8)	2.9	0.9
Gross margin (%)		38.2%	46.5%	46.0%	52.6%	45.5%
EBITDA margin (%)		(121.3%)	(25.4%)	(16.0%)	25.1%	10.1%
Operating margin (before GW and except.) (%)		(130.9%)	(32.6%)	(21.0%)	23.5%	8.2%
BALANCE SHEET						
Fixed assets		1,182	1,321	1,134	1,108	1,108
Intangible assets		0	611	672	678	678
Tangible assets		1,182	710	462	430	430
Investment in associates		0	0	0	0	0
Unquoted investments		0	0	0	0	0
Current assets		7,650	10,255	7,620	14,915	15,964
Stocks		2,777	2,613	2,821	4,500	4,500
Debtors		4,025	2,734	2,600	3,600	2,340
Cash		848	4,908	2,199	6,815	9,124
Other		0	0	0	0	0
Current liabilities		(6,009)	(3,500)	(2,858)	(4,650)	(4,552)
Creditors		(1,726)	(661)	(543)	(750)	(652)
Other creditors		(4,283)	(2,682)	(2,257)	(3,900)	(3,900)
Short-term borrowings		0	(157)	(58)	0	0
Minority interests		0	0	0	0	0
Long-term liabilities		(224)	(35)	0	0	0
Long-term borrowings		(213)	(34)	0	0	0
Other long-term liabilities		(11)	(1)	0	0	0
Net assets		2,599	8,041	5,896	11,373	12,520
CASH FLOW						
Operating cash flow		(10,448)	(5,413)	(2,978)	4,579	2,484
Net interest		658	225	150	65	100
Tax		599	95	550	(15)	(25)
Capex		(424)	(112)	(149)	(350)	(250)
Acquisitions/disposals		0	387	(65)	(30)	0
Financing		2,154	8,878	(107)	425	0
Dividends		0	0	0	0	0
Other		0	0	0	0	0
Net cash flow		(7,461)	4,060	(2,599)	4,674	2,309
Opening net debt/(cash)		(16,561)	(635)	(4,717)	(2,141)	(6,815)
HP finance leases initiated		0	0	0	0	0
Other		(8,465)	22	23	0	0
Closing net debt/(cash)		(635)	(4,717)	(2,141)	(6,815)	(9,124)

Source: Company accounts/Edison Investment Research

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